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Boulogne, G.F.

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Safeguarding the financial interests of the Member States under Article 8 of the EU Merger Directive and the pending Marc Lassus (C-421/16) and Finnish exit tax case (C-292/16)

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Frederik Boulogne (PwC Netherlands (currently seconded to PwC Singapore), VU University Amsterdam (VU Nexus Centre))

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The objective of the EU Merger Directive ("MD") is to remove tax obstacles to cross-border restructuring operations while safeguarding the financial interests of the Member States.^[1] In aligning these two aims, the MD employs a carry-over relief mechanism at both company and shareholder level. Through the carry-over mechanism at shareholder level, laid down in Article 8 MD, taxation can be deferred until the shareholder actually disposes of the shares received. Article 8 MD reflects the notion that – from the perspective of the shareholder – the restructuring operation is only a 'paper-for-paper' transaction: shares held in one or more companies are substituted for shares in one or more other companies.

In this contribution, I assess the effectiveness of the carry-over mechanism at shareholder level in light of the aim of safeguarding the financial interests of the Member States.

Description of Article 8 MD

Article 8(1) and 8(2) MD provide that the allotment of shares representing the capital of the receiving or acquiring company to a shareholder of the transferring or acquired company in exchange for shares representing the capital of the latter company does not lead to taxation:

1. On a merger, division or exchange of shares, the allotment of securities representing the capital of the receiving or acquiring company to a shareholder of the transferring or acquired company in exchange for securities representing the capital of the latter company shall not, of itself, give rise to any taxation of the income, profits or capital gains of that shareholder.
2. On a partial division, the allotment to a shareholder of the transferring company of securities representing the capital of the receiving company shall not, of itself, give rise to

any taxation of the income, profits or capital gains of that shareholder.

If a Member State refrains from taxing the shareholder on its 'income, profits or capital gains', Article 8(4) and 8(5) MD impose the condition that the shareholder does not attribute to the shares received values for tax purposes higher than the values the shares exchanged had:

4. Paragraphs 1 and 3 shall apply only if the shareholder does not attribute to the securities received a value for tax purposes higher than the value the securities exchanged had immediately before the merger, division or exchange of shares.

5. Paragraphs 2 and 3 shall apply only if the shareholder does not attribute to the sum of the securities received and those held in the transferring company, a value for tax purposes higher than the value the securities held in the transferring company had immediately before the partial division.

Questions triggered by Article 8 MD

Article 8 MD triggers the following three questions:

- Of which Member State should the financial interests be safeguarded?
- Is the carry-over requirement adequate in safeguarding the financial interests of the Member States?
- Does the carry-over requirement ensure that Member States do not go beyond what is necessary to safeguard their financial interests?

Of which Member State should the financial interests be safeguarded?

Two different Member States potentially tax a shareholder upon a restructuring operation: (i) the Member State in which the shareholder is resident and (ii) the Member State in which its shareholding is resident. As Article 8(1) and 8(2) MD use the broad wording "shall not, of itself, give rise to any taxation", it is not clear which Member State should refrain from immediate taxation and of which Member State the financial interests should consequently be safeguarded. I therefore examine this question from the perspective of both Member States.

The Member State of the shareholder

Many Member States exempt from taxation capital gains derived by a shareholder from the cancellation / transfer of a qualifying shareholding. In those cases, if the Member State of the shareholder already exempts a capital gain under its domestic law, it is not necessary to have recourse to the carry-over facility in Article 8 MD.

If the Member State of the shareholder taxes the shareholder on its capital gain, it is, as a main rule, not prevented from doing so if the Member State of the shareholder and the Member State of the shareholding have concluded a tax treaty that is in accordance with the OECD Model Convention. In that case, the gain from the cancellation/transfer of the shares by the shareholder is taxable only in the Member State of the shareholder ('the Contracting State of which the alienator is a resident', Article 13(5) of the OECD Model Convention). To this main rule, Article 13(4) of the OECD Model Convention contains an exception if the shareholding is a so-called 'immovable property company', in which case the right to tax the gain is allocated to the Member State of the shareholding.

As long as the regime applicable to the shareholding does not change as a result of the shareholding (see below), the carry-over requirement in Article 8(4) and 8(5) MD is suitable to safeguard the taxing rights of the Member State of the shareholder.

The Member State of the shareholding

As mentioned, if the tax treaty between the Member State of the shareholder and the Member State of the shareholding is patterned upon the OECD Model Convention, the Member State of the shareholding will be prevented from taxing a capital gain from the cancellation/transfer of the shares received by the shareholder, unless the shareholding is an 'immovable property company'.

Even if the applicable tax treaty does not prevent the Member State of the shareholding from taxing the shareholder, since a capital gain derived by a resident shareholder is typically not taxable in the Member State of the shareholding, such taxation could be in breach of primary EU law.

In my doctoral thesis^[2] I presented an example that shows that Article 8(4) and 8(5) MD are inadequate in safeguarding the financial interests of the Member State of the shareholding if the receiving company is resident in another Member State than the transferring company. In spite of the shareholder valuing the shares received at the same values that the shares exchanged had immediately before the restructuring operation, the Member State of the shareholding loses its taxing rights.

Another example I presented shows that even if the shareholding is not dissolved, the Member State of the shareholding may lose the taxing rights that it had prior to the exchange of shares.

My conclusion is that the carry-over requirement in Article 8(4) and 8(5) MD does not adequately safeguard the financial interests of the Member State of the shareholding.

Is the carry-over requirement adequate in safeguarding the financial interests of the Member States?

I just observed that the carry-over requirement in Article 8(4) and 8(5) MD does not adequately safeguard the financial interests of the Member State of the shareholding. Generally, this requirement is adequate in safeguarding the financial interests of the Member State of the shareholder, with one exception: when the regime applicable to the shareholding changes.

Take, for instance, an exchange of shares whereby a shareholder exchanges a 3%-shareholding in the acquired company for a 10%-shareholding in the acquired company. If the threshold for the application of a domestic exemption in the Member State of the shareholder is 5%, a capital gain derived with the alienation of the shareholding in the acquiring company will be exempt under a domestic exemption, whereas the alienation of the shares in the acquired company would not have been eligible for any relief, or only for a (fictitious) tax credit. Even if the shareholder values the shares in the receiving company at the same values that the shares in the transferring company had, the Member State of the shareholder loses the taxing rights it had prior to the restructuring operation. As it is not guaranteed that the same 'taxable regime' also applies to the shares received, Article 8(4) and 8(5) MD come short in safeguarding the financial interests of the Member State of the shareholder. As a solution, Article 8(6) MD comes into play:

6. The application of paragraphs 1, 2 and 3 shall not prevent the Member States from taxing the gain arising out of the subsequent transfer of the securities received in the same way as the gain arising out of the transfer of securities existing before the acquisition.

Member States are thus entitled to apply the same regime to the gain arising out of the transfer of the shares received as the regime applicable before the restructuring operation, although the wording of Article 8(6) ('shall not prevent the Member States') also leaves Member States the discretion to apply the new regime if that is more advantageous to them.

Article 8(6) MD refers to the taxation of a gain in a certain way ('in the same way'), but it does not fix the amount of the taxable gain. That is, it does not give the Member State of the shareholder the right to tax the amount of the gain that it would have been able to tax at the time of the restructuring operation.

The question therefore arises whether the right to tax the gain 'in the same way' as before the restructuring operation covers the entire amount of the gain, or only that part of the gain that can be apportioned to the period before the restructuring operation.

The pending *Marc Lassus* case (C-421/16) raises the question if a Member State is allowed to fix the amount of tax due on a capital gain at the time of the restructuring operation and collect the proportionate amount of tax when the shareholder subsequently sells the shares received. Such a mechanism seems to be a deviation from the envisaged carry-over mechanism under the MD whereby a taxpayer carries over the balance-sheet values of the shareholding and a Member State ultimately taxes that taxpayer on the difference between the real values and the balance-sheet values of the shareholding (if positive). The question in the *Marc Lassus* case is if the 'deferral of payment' mechanism of fixing the amount of tax and deferring the collection until (deemed) realisation that we know from the ECJ's case-law in the area of primary EU law (e.g. the *De Lasteyrie du Saillant* (C-9/02) and *N* (C-470/04) cases) can be 'imported' into the Merger Directive's ambit.

The *Marc Lassus* case concerns a French national who moved to the United Kingdom in 1997. In 1999 he exchanged his shares in a French company for shares in a Luxembourg company. In 2002 he sold part of his shares in the Luxembourg company to a French company at a loss. In 1999, under a specific provision in the capital gains article in the UK-France tax treaty, France was still allowed to tax the capital gain arising at the time of the exchange of shares and pursuant to a provision in French law, the tax on that capital gain was fixed. In 2002, even though France was no longer allowed to tax under the applicable UK-France treaty, a proportional part of the tax that was fixed in 1999 was collected from the taxpayer.

The case raises several questions:

- Is France allowed to fix a tax claim and later recover it under the EU Merger Directive even though it has surrendered its taxing rights under the applicable tax treaty?
- If so, is France also allowed to tax when the subsequent transfer results in a loss (in a domestic situation, a taxpayer would have been able to benefit from a tax credit derived from the loss on the transfer)?
- If account must be taken of the loss, how? By offsetting the loss against the fixed capital gain or by foregoing the taxation of the capital gain on the exchange?
- If the loss may be offset, what purchase price must be used for the shares transferred to calculate the loss on that transfer?

In my view, the first question reaches the core of the MD's system. In the *National Grid Indus* case (C-371/10), a company transferred its seat from the Netherlands to the United Kingdom without leaving a permanent establishment behind. That restructuring operation, within the scope of the Merger Directive, could not benefit from the absence of immediate taxation at company level (Article 4(1) MD) as the requirement in Article 4(2)(b) MD that a taxable permanent establishment remain behind, was not met.

By contrast, in the *Marc Lassus* case, the requirement in Article 8(4) MD that the shareholder values the shares received at the balance-sheet values that the shares exchanged had may have been met by the shareholder (I cannot retrieve this from the documents available at curia.europa.eu). The question is then whether France is still allowed to tax the shareholder, even though it is no longer allowed to do so under the applicable tax treaty. In view of the *3D I Srl* case (C-207/11) discussed below, Article 8(1) MD solely seems to prohibit the shareholder from being taxed on a capital gain at the time of the restructuring operation, but does not govern the taxation at a later stage. If France can be considered to exercise its right under Article 8(6) MD to “tax(...) the gain arising out of the subsequent transfer of the securities received in the same way as the gain arising out of the transfer of securities existing before the acquisition” it has to be assessed in the light of primary EU law whether such taxation would be allowed and whether a loss should be taken into account.

Does the carry-over requirement ensure that Member States do not go beyond what is necessary to safeguard their financial interests?

Since Article 8(4) and 8(5) MD only cover the valuation of shares received by the ‘shareholder’, the valuation of shares received by other persons is outside the realm of the MD. This potentially leaves in place double taxation of effectively the same capital gain.

The *3D I Srl* case (C-207/11) concerned an Italian resident company, 3D I Srl, that had transferred an Italian branch of activity to a Luxembourg company. The Italian regime for carry-over relief required 3D I Srl to create a reserve fund in its balance-sheet if the shares received in the Luxembourg company were attributed higher balance-sheet values than the values of the assets and liabilities transferred. Upon distribution of the gain to the shareholder, this reserve would have constituted taxable income. The ECJ held that the Merger Directive:[3]

leaves it to the Member States’ discretion as to whether or not the fiscal neutrality from which the transferring company benefits is to be made subject to obligations to value the securities received in exchange, such as maintaining the continuity of values for tax purposes, provided that those obligations do not have the consequence that the issue of those securities during the transfer of assets itself gives rise to taxation of the capital gains relating to those assets.

The *3D I Srl* case thus clarifies that where the MD is silent, Member States retain discretionary powers to make the Directive’s benefits dependent on additional conditions (such as valuation rules), unless these conditions give rise to the taxation of capital gains at the time of the restructuring operation.

The *3D I Srl* case should be distinguished from the *A.T.* case (C-285/07), which was decided four years earlier. In that case, German company A exchanged its shareholding in German company B for shares in a French company. As a result of the ‘double carryover of the book value rule’ in the German legislation, German company A was only entitled to carry-over relief if the French company valued the shares received in German company B at the same values that those shares had in the hands of German company A prior to the exchange of shares. This was a valuation rule that does not occur in Article 8 MD. The ECJ decided that the German legislation was in breach of the clear wording and objective of the MD and that it was disproportional to prevent tax avoidance.

The *3D I Srl* and *A.T.* cases clarify that it is not in breach of the MD if Member States impose valuation rules in addition to Article 8(4) and 8(5) MD, provided that those rules do not lead to taxation at the time of the restructuring operation. But the *3D I Srl* and *A.T.* cases also expose *lacunae* in Article 8 MD: as this provision does not address the valuation of (i) the shares received by the transferring

company in a transfer of assets and (ii) the shares received by the acquiring company in an exchange of shares, potentially a dual claim is imposed on effectively the same hidden reserves. If a Member State indeed safeguards its taxing rights through two different routes (by requiring both the shares received by the transferring company and the transferred assets and liabilities to be valued at their balance-sheet values) the question is whether the transferred assets and liabilities can be disposed of without taxation as the Member State of the transferring company retains a claim on the shares received. In the *DMC* case (C-164/12) the ECJ appears to have left open the question if Germany would be able to invoke the objective of preserving a balanced allocation of taxing powers if, in spite of losing the powers to tax the Austrian resident limited partners, it would be able to take later capital gains into account at the level of the acquiring German-resident capital company.^[4]

A-G Kokott's Opinion in the Finnish exit tax case (C-292/16)

The pending case C-292/16 concerns a Finnish resident company that incorporates an Austrian permanent establishment into an Austrian-resident company. Finland immediately taxed the hidden reserves in the foreign permanent establishment while granting a fictitious credit for the tax in the Member State where the permanent establishment was situated. A domestic transfer of a permanent establishment would not have triggered immediate taxation in Finland. Although Article 10(2) MD allows Finland to tax the hidden reserves in the transferred permanent establishment, the question referred to the ECJ is whether also immediate taxation is allowed, given the ECJ's exit tax case-law (e.g. *National Grid Indus* (C-371/10), *DMC* (C-164/12), and *Verder LabTec* (C-657/13)) in which only deferred exit taxation was found to be proportional.

The relevance for this contribution of A-G Kokott's Opinion of 13 July 2017 is that it contains a misunderstanding of Article 8 MD. On the justification of the Finnish exit tax she writes in paras. 35 and 36 (unofficial translation; curia.europa.eu does not contain an English language version):

35. Contrary to a classic exit tax, in the case of a contribution against issue of shares only the shares in the acquiring company become part of the taxing jurisdiction of the State of departure. There is only a sort of exchange of assets (at the debit side of the balance-sheet). Article 8, paragraph 2, second sentence, of the Merger Directive explicitly allows that the gains from a later disposal of the shares received are taxed. For the hidden reserves that will arise in the permanent establishment in the future, the Finnish taxing jurisdiction will therefore indirectly continue to exist.

36. The taxing jurisdiction with respect to the shares in a foreign-resident company is, however, something different compared to the taxing jurisdiction with respect to the assets of a foreign permanent establishment. The shares received are something different than the assets of the foreign permanent establishment. For that reason it remains a fact that the hidden reserves that arose in the permanent establishment have definitely been withdrawn from taxation. This creates a legitimate right for a (final) taxation by the Member State that loses its direct taxing right.

Further on in her Opinion, addressing the question whether the Finnish exit tax could be proportional owing to the fictitious tax credit, A-G Kokott writes:

51. If in the comparable domestic situation no tax is levied on restructuring measures with a view to preserving the allocation of taxing rights, an equally suitable, less far-reaching means is a deferral of taxation or a levy spread over a certain period of the (often lower) taxation with restructuring measures in a domestic situation.

52. *This applies a fortiori in the case at hand, since through Article 8, paragraph 2, of the Merger Directive – other than in the cases of the classic exit taxation – an indirect taxing jurisdiction on future capital gains of the permanent establishment even continues to exist. However, if an indirect share in future value changes continues to exist, an immediate taxation (at a fixed tax rate) seems even less proportional than with a departure where all ties with taxable assets are broken.*

A-G Kokott's findings that "Article 8, paragraph 2, second sentence, of the Merger Directive explicitly allows that gains from a later disposal of the shares received are taxed" and that through Article 8(2) MD "an indirect taxing jurisdiction on future capital gains of the permanent establishment continues to exist" do not follow from Article 8(2) MD itself. As reiterated, Article 8(2) MD reads:

2. On a partial division, the allotment to a shareholder of the transferring company of securities representing the capital of the receiving company shall not, of itself, give rise to any taxation of the income, profits or capital gains of that shareholder.

First, Article 8(2) MD does not apply to transfers of assets (the restructuring operation in case C-292/16), but only to partial divisions. Article 9 MD, which reads: "Articles 4, 5 and 6 shall apply to transfers of assets" does not mention Article 8 MD. Second, Article 8(2) MD does not explicitly allow anything. Rather, it prohibits taxation of the shareholder at the time of the restructuring operation. Third, Article 8(2) MD does not create an indirect taxing jurisdiction on the permanent establishment transferred. Perhaps, if one would incorrectly read Article 8(2) MD as covering transfers of assets too, one could conclude that it does not prohibit the Member State of the transferring company from requiring that the shares received be valued at carried-over balance-sheet values, thereby allowing the creation of an indirect taxing jurisdiction on the permanent establishment transferred.

In view of these misunderstandings, it seems odd to invoke Article 8(2) MD as additional argument for the conclusion that primary EU law requires Finland to levy a more proportional exit tax than the immediate taxation with fictitious tax credit. That conclusion can stand by its own.

Recommendations for an improved Article 8 MD

In this contribution I identified several areas where the carry-over mechanism in Article 8 MD is either inadequate in safeguarding the financial interests of the Member States or does not ensure that Member States do not go beyond what is necessary to safeguard their financial interests (and hence, leave tax obstacles to cross-border restructuring in place).

First, the carry-over mechanism does not adequately safeguard the financial interests of the Member State of the shareholding. It fits within the scheme of the MD if also the financial interests of that Member State would be safeguarded. A 'taxation leak' – the Member State of the shareholding has to refrain from taxation, while future taxation is not safeguarded – does not tally well with the MD's objective of safeguarding taxing rights. On the one hand, it is possible that the EU legislator was not aware of this 'taxation leak' when drafting Article 8 MD. Or, perhaps, it was aware of this 'taxation leak', but Article 8 MD was drafted inadequately. On the other hand, it is also possible that the EU legislator purposely sought to safeguard only the taxing rights of the Member State of the shareholder and not those of the Member State of the shareholding, in line with Article 13(5) of the OECD Model Convention. This, however, would be odd, since EU law generally does not interfere in the allocation of taxing rights between the Member States. To repair the 'taxation leak', the Member State of the shareholding is in principle allowed to secure future taxing rights, but this is difficult if no taxable nexus remains or this would require a renegotiation of the newly applicable tax treaty. A solution is to

make the obligation to refrain from taxation in Article 8(1) and 8(2) MD conditional upon a requirement that future taxation of the capital gain is ensured (similar to the 'taxable income requirement' in Article 4(2)(b) MD).

Second, the carry-over mechanism does not safeguard the financial interests of the Member State of the shareholder if it is no longer allowed, under the applicable tax treaty, to tax the shareholder when he disposes of the shares received. Arguably, Article 8(6) MD allows the Member State of the shareholder to tax, but it should be clarified in the MD that (i) this taxing right only covers that part of the capital gain that can be apportioned to the period before the restructuring operation and (ii) the principles set out in *De Lasteyrie du Saillant* and *N* (e.g. future losses are taken into account, no interest is charged and no bank guarantees are required) are respected.

Third, by not addressing the valuation of (i) the shares received by the transferring company in a transfer of assets and (ii) the shares received by the acquiring company in an exchange of shares, the MD potentially leaves double taxation of effectively the same capital gain in place. In line with the suggestions in the Commission's 2003 Proposal for the amendment of the Merger Directive,^[5] the solution is to insert the following provisions as Article 9(2) and 8(10) respectively:

2. The securities representing the capital of the receiving company, received in exchange for the transfer of assets by the transferring company, shall have attributed to them the real value that the assets and liabilities transferred had immediately before the transfer of assets.

and:

10. The acquiring company in an exchange of shares shall attribute to the securities received the real value of the securities issued to the shareholders of the acquired company.

[1] See the third, fourth and fifth recitals in the preamble to the Merger Directive.

[2] G.F. Boulogne, *Shortcomings in the EU Merger Directive* (Series on International Taxation Vol. 57), Alphen aan den Rijn: Kluwer Law International 2016, at pp. 185-186.

[3] Case C-207/11, *3D I Srl v Agenzia delle Entrate - Ufficio di Cremona* [19 Dec. 2012] ECLI:EU:C:2012:433 (para. 30).

[4] Case C-164/12, *DMC Beteiligungsgesellschaft mbH v Finanzamt Hamburg-Mitte* [23 Jan. 2014] ECLI:EU:C:2014:20 (para. 57).

[5] Proposal for a Council Directive amending Directive 90/434/EEC of 23 Jun. 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States, COM(2003) 613 final – CNS 2003/0239, Commission of the European Communities, 17 Oct. 2003.